

Letter of Findings Number: 04-20130249
Use Tax
For Tax Years 2008-10

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective as of its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.

ISSUE

I. Use Tax—Imposition.

Authority: Mason Metals Company, Inc. v. Ind. Dep't of State Revenue, 590 N.E.2d 672 (Ind. Tax 1992); Mechanics Laundry & Supply Co., Inc. v. Ind. Dep't of State Revenue, 650 N.E.2d 1223 (Ind. Tax 1995); IC § 6-2.5-1-21; IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-5-3; IC § 6-8.1-5-1; [45 IAC 2.2-3-4](#); [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-14](#); [45 IAC 2.2-5-15](#).

Taxpayer protests the imposition of use tax.

STATEMENT OF FACTS

Taxpayer is an Indiana business providing equipment rental and related services. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer had not paid sales tax at the time it purchased certain tangible personal property ("TPP") during the tax years 2008, 2009, and 2010. The Department therefore issued proposed assessments for use tax and interest. Taxpayer protested that the proposed assessments included imposition of use tax on some exempt purchases. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Use Tax—Imposition.

DISCUSSION

Taxpayer protests the imposition of use tax on certain purchases during the tax years 2008, 2009, and 2010. The Department based its proposed assessments of use tax for those years on the grounds that Taxpayer was renting equipment both with and without an operator, but did not pay sales tax on certain purchases for equipment which was rented with an operator. Since purchases of TPP used in such a manner are subject to sales tax when purchased by the entity renting the equipment, and since sales tax was not paid at the time of purchase by Taxpayer, the Department issued proposed assessments for use tax. The Department used a sample and projection method to determine Taxpayer's compliance rate for ordinary purchases. That rate was applied to Taxpayer's total ordinary purchases for all three years. The Department credited any sales and use taxes already remitted on such purchases and applied use tax to the remaining amounts at the previously calculated compliance rate. The Department then reviewed all capital asset purchases to determine the taxable status of such purchases.

Taxpayer protests that the equipment was often rented without an operator and that the rental was therefore taxable to its customers and exempt when it purchased the TPP. The Department notes that the burden of proving a proposed assessment wrong rests with the person upon whom the proposed assessment is made, as provided by IC § 6-8.1-5-1(c).

Sales tax is imposed by IC § 6-2.5-2-1, which states:

- (a) An excise tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana.
- (b) The person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state.

Use tax is imposed under IC § 6-2.5-3-2(a), which states:

An excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction.

[45 IAC 2.2-3-4](#) further explains:

Tangible personal property, purchased in Indiana, or elsewhere in a retail transaction, and stored, used, or otherwise consumed in Indiana is subject to Indiana use tax for such property, unless the Indiana state gross retail tax has been collected at the point of purchase.

Therefore, when tangible personal property is used, stored, or consumed in Indiana, use tax is due unless sales tax was paid at the time of the transaction.

Also of relevance is IC § 6-2.5-5-8(b), which states:

Transactions involving tangible personal property other than a new motor vehicle are exempt from the state gross retail tax if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of the person's business without changing the form of the property.

The exemption is further clarified by [45 IAC 2.2-5-15](#), which states:

- (a) The state gross retail tax shall not apply to sales of any tangible personal property to a purchaser who purchases the same for the purpose of reselling, renting or leasing, in the regular course of the purchaser's business, such tangible personal property in the form in which it is sold to such purchaser.
- (b) General rule. Sales of tangible personal property for resale, rental or leasing are exempt from tax if all of the following conditions are satisfied:
- (1) The tangible personal property is sold to a purchaser who purchases this property to resell, rent or lease it;
 - (2) The purchaser is occupationally engaged in reselling, renting or leasing such property in the regular course of his business; and
 - (3) The property is resold, rented or leased in the same form in which it was purchased.
- (c) Application of general rule.
- (1) The tangible personal property must be sold to a purchaser who makes the purchase with the intention of reselling, renting or leasing the property. This exemption does not apply to purchasers who intend to consume or use the property or add value to the property through the rendition of services or performance of work with respect to such property.
 - (2) The purchaser must be occupationally engaged in reselling, renting or leasing such property in the regular course of his business. Occasional sales and sales by servicemen in the course of rendering services shall be conclusive evidence that the purchaser is not occupationally engaged in reselling the purchased property in the regular course of his business.
 - (3) The property must be resold, rented or leased in the same form in which it was purchased.

(Emphasis added).

Therefore, if TPP is purchased for resale, rental, or leasing in the ordinary course of the purchaser's business, it is exempt from sales and use taxes unless the purchaser uses or consumes the property through the rendition of services or performance of work with respect to such property, as provided by IC § 6-2.5-5-8(b) and [45 IAC 2.2-5-15\(c\)\(1\)](#). The Department determined that Taxpayer had provided services or performance of work in connection with the rental of TPP at issue in this protest, and so imposed use tax since sales tax was not paid at the time of purchase.

Regarding the first category of purchases under protest, Taxpayer protests that the TPP in question was rented to its customers for extended periods of time and that the TPP would be used both by Taxpayer's employees and by its customer's employees. Taxpayer further explains that, even if its employees used the equipment, its employees were under the direct supervision and control of the customers' employees. Such use, Taxpayer argues, constitutes rental of TPP which is subject to sales or use tax and thus the purchase of the TPP by Taxpayer is exempt under IC § 6-2.5-5-8(b).

The Department considered that Taxpayer has two types of rental/leases: 1) TPP alone; and, 2) TPP with an operator. The Department concluded that the rentals with an operator were the provision of services and were not subject to sales tax while the provision of TPP alone did constitute a rental and was subject to sales tax. The Department therefore imposed use tax on Taxpayer's purchases of TPP used in rentals of TPP with an operator. In reaching its determination, the Department referred to IC § 6-2.5-1-21, which states:

- (a) "Lease" or "rental" means any transfer of possession or control of tangible personal property for a fixed or indeterminate term for consideration and may include future options to purchase or extend. "Lease" or "rental" does not include:
- (1) a transfer of possession or control of property under a security agreement or deferred payment plan that requires the transfer of title upon completion of the required payments;
 - (2) a transfer of possession or control of property under an agreement that requires the transfer of title upon completion of required payments and payment of an option price that does not exceed the greater of one hundred dollars (\$100) or one percent (1[percent]) of the total required payments; or
 - (3) providing tangible personal property along with an operator for a fixed or indeterminate period, if:
 - (A) the operator is necessary for the equipment to perform as designed; and
 - (B) the operator does more than maintain, inspect, or set up the tangible personal property.
- (b) "Lease" or "rental" includes agreements covering motor vehicles and trailers in which the amount of consideration may be increased or decreased by reference to the amount realized upon sale or disposition of the property as defined in 26 U.S.C. 7701(h)(1).
- (c) The definition of "lease" or "rental" set forth in this section applies throughout this article, regardless of whether a transaction is characterized as a lease or rental under generally accepted accounting principles, the Internal Revenue Code, the uniform commercial code ([IC 26-1](#)), or other provisions of federal, state, or local law.
- (d) This section applies only to leases or rentals entered into after June 30, 2003, and has no retroactive effect on leases or rentals entered into before July 1, 2003.

(Emphasis added).

Also relevant is [45 IAC 2.2-4-27](#), which states in relevant part:

- (a) In general, the gross receipts from renting or leasing tangible personal property are taxable. This

regulation [\[45 IAC 2.2\]](#) only exempts from tax those transactions which would have been exempt in an equivalent sales transaction.

(b) Every person engaged in the business of the rental or leasing of tangible personal property, other than a public utility, shall be deemed to be a retail merchant in respect thereto and such rental or leasing transaction shall constitute a retail transaction subject to the state gross retail tax on the amount of the actual receipts from such rental or leasing.

(c) In general, the gross receipts from renting or leasing tangible personal property are subject to tax. The rental or leasing of tangible personal property constitutes a retail transaction, and every lessor is a retail merchant with respect to such transactions. The lessor must collect and remit the gross retail tax or use tax on the amount of actual receipts as agent for the state of Indiana. The tax is borne by the lessee, except when the lessee is otherwise exempt from taxation.

(d) The rental or leasing of tangible personal property, by whatever means effected and irrespective of the terms employed by the parties to describe such transaction, is taxable.

(1) Amount of actual receipts. The amount of actual receipts means the gross receipts from the rental or leasing of tangible personal property without any deduction whatever for expenses or costs incidental to the conduct of the business. The gross receipts include any consideration received from the exercise of an option contained in the rental or lease agreement; royalties paid, or agreed to be paid, either on a lump sum or other production basis, for use of tangible personal property; and any receipts held by the lessor which may at the time of their receipt or some future time be applied by the lessor as rentals.

(2) Rental or lease period. For purposes of the imposition of the gross retail tax or use tax on rental or leasing transactions, each period for which a rental is payable shall be considered a complete transaction. In the case of a weekly rate, each week shall be considered a complete transaction. In the case of a continuing lease or contract, with or without a definite expiration date, where rental payments are to be made monthly or on some other periodic basis, each payment period shall be considered a completed transaction.

(3) Renting or leasing property with an operator:

(A) The renting or leasing of tangible personal property, together with the services of an operator shall be subject to the tax when control of the property is exercised by the lessee. Control is exercised when the lessee has exclusive use of the property, and the lessee has the right to direct the manner of the use of the property. If these conditions are present, control is deemed to be exercised even though it is not actually exercised.

(B) The rental of tangible personal property together with an operator as part of a contract to perform a specific job in a manner to be determined by the owner of the property or the operator shall be considered the performance of a service rather than a rental or lease provided the lessee cannot exercise control over such property and operator.

(C) When tangible personal property is rented or leased together with the service of an operator, the gross retail tax or use tax is imposed on the property rentals. The tax is not imposed upon the charges for the operator's services, provided such charges are separately stated on the invoice rendered by the lessor to the lessee.

(4) Supplies furnished with leased property. A person engaged in the business of renting or leasing tangible personal property is considered the consumer of supplies, fuels, and other consumables which are furnished with the property which is rented or leased.

(Emphasis added).

The Indiana Tax Court has also addressed this issue in *Mason Metals Company, Inc. v. Ind. Dep't of State Revenue*, 590 N.E.2d 672 (Ind. Tax Ct. 1992), where it provided:

Although the language of Mason's lease agreements purports to give Mason the right to direct the manner of the tractor's use, the evidence shows Mason actually had no such right. The tractor's drivers were employees of American, and American directed the drivers' actions. Mason also had no control over the routes taken by the drivers in getting to their destinations. Moreover, the tractor was not used exclusively to haul Mason's products. Accordingly, Mason did not have the possession and control of the tractor, under either the Indianapolis Transit test or under 45 I.A.C. 2.2-4-27(d)(3), necessary to characterize its transactions as a leasing of property subject to sales and use tax.

Id at 676.

In the instant case, Taxpayer has shown by documentation and explanation that while it did provide operators for the TPP it rented to its customers for some of those rentals, those customers also had sole control and direction of the TPP and the operators' actions. In some cases, the customers directly used the TPP without Taxpayer's operator's involvement, even if the rental agreement called for TPP with an operator. In either case, the rental transaction is subject to sales tax, as provided by [45 IAC 2.2-4-27\(d\)\(3\)\(A\)](#) and (C), and by *Mason Metals*.

Also, since Taxpayer's customers could operate the equipment without Taxpayer's employees, Taxpayer's employees were not necessary to operate the equipment and so the rental arrangement was considered a rental

of TPP under IC § 6-2.5-1-21(a)(3). Since the rental/lease transactions are considered rentals of TPP and are subject to sales tax, Taxpayer's purchase of such TPP is eligible for the rental exemption found under IC § 6-2.5-5-8(b) and [45 IAC 2.2-5-15](#) and is therefore not subject to use tax on Taxpayer's purchase of such TPP. Therefore, while it was logical for the Department to have initially considered the rental of TPP with an operator to be a service, Taxpayer has met the burden imposed under IC § 6-8.1-5-1(c). The Department takes this opportunity to note that it will expect Taxpayer, as a retail merchant involved in retail transactions, to collect sales tax on both rental/leases of TPP alone and rental/leases of TPP with an operator.

The second category of purchases under protest involves purchases of repair and replacement parts for the rental equipment. In its audit report, the Department explained that due to the large number of purchases during the audit years, it would use a sample and projection method to determine the percentage of repair parts which were taxable and the percentage which were exempt. The Department used these calculations to arrive at a compliance percentage which was then applied to Taxpayer's total purchases for the tax years at issue.

The starting point for the calculations to reach the compliance percentage was to apply the same taxable and exempt percentages as determined in the rental/lease of TPP, as discussed above and as provided by [45 IAC 2.2-5-15\(a\)](#), which states:

The state gross retail tax shall not apply to sales of any tangible personal property to a purchaser who purchases the same for the purpose of reselling, renting or leasing, in the regular course of the purchaser's business, such tangible personal property in the form in which it is sold to such purchaser.

The Department therefore determined that some repair parts were taxable to Taxpayer when they were installed in equipment which was used in the rendition of services via equipment rental with operators and that some repair parts were exempt when they were installed in equipment which was used in the rental of TPP without an operator.

As explained above, both types of rental/leases were subject to sales tax on the rental/leases and so Taxpayer's purchases with regard to the TPP were exempt as purchases for rental. Similarly, the repair parts incorporated into all of the equipment involved in both types of rental/lease are also exempt under [45 IAC 2.2-5-15\(a\)](#). Therefore, Taxpayer's purchases of repair parts for rental/leasing equipment were wholly exempt from sales and use tax and the Department will therefore recalculate the compliance percentage after removing repair parts for rental/leasing equipment. The Department will then apply the recalculated compliance percentage to Taxpayer's total purchases for the tax years at issue. For the second category of items under protest, Taxpayer has met the burden imposed under IC § 6-8.1-5-1(c).

The third category of purchases under protest is raw materials such as steel plate and steel bars which Taxpayer used to fabricate parts for the equipment in question. The Department reviewed Taxpayer's records and determined that Taxpayer had sold a certain percentage of the manufactured replacement parts. The Department therefore imposed use tax on the percentage of raw materials which it had determined that Taxpayer used to make parts it directly used itself in the provision of services. The Department did not impose use tax on the percentage of raw materials used to make parts that Taxpayer sold to its customers in routine retail transactions.

Taxpayer protests that its use of the raw materials to produce the parts is non-taxable and refers to *Mechanics Laundry & Supply Co., Inc. v. Ind. Dep't of State Revenue*, 650 N.E.2d 1223 (Ind. Tax Ct. 1995), in which the Indiana Tax court explained:

While the laundering of soiled textiles does not constitute the production of goods or other tangible personal property, the parties, by joint stipulation, agree that Mechanics Laundry "produces or manufactures" over 90 percent of the logos and name [tags] Petitioner's Exhibit 1 at 14–15, ¶ 59, ¶ 60 & ¶ 62. Thus, Mechanics Laundry's purchases of "manufacturing machinery, tools, and equipment" used to produce logos and name tags are exempt from the sales tax under I.C. 6–2.5–5–3.

Id. at 1230.

Taxpayer believes that Mechanics Laundry supports its position that the raw materials are consumed in the production of other tangible personal property. The Department notes that the court in *Mechanics Laundry* states that Mechanics Laundry's purchases of manufacturing machinery, tools, and equipment used in production were exempt via stipulation by both parties in that case. The court did not address Mechanics Laundry's purchase of raw materials used to make the logos and tags.

The first relevant regulation is [45 IAC 2.2-5-14](#), which states:

(a) The state gross retail tax shall not apply to sales of any tangible personal property which is to be incorporated by the purchaser as a material or an integral part into tangible personal property produced for sale by such purchaser in the business of manufacturing, assembling, refining or processing.

(b) The exemption provided by this regulation [[45 IAC 2.2](#)] applies only to tangible personal property to be incorporated as a material or an integral part into tangible personal property produced for sale by a purchaser engaged in the business of manufacturing, assembling, refining or processing. This regulation [[45 IAC 2.2](#)] does not apply to persons engaged in producing tangible personal property for their own use.

(c) This regulation [[45 IAC 2.2](#)] does not exempt from tax tangible personal property to be used in production, such as supplies, parts, fuel, machinery, etc., refer to Regs. 6-2.5-5-5(010) and 6-2.5-5-5(020) (dealing with material consumed in direct production) for the application of those regulations to taxpayers engaged in the

production of tangible personal property.

(d) The purchase of tangible personal property which is to be incorporated by the purchaser as a material or an integral part is exempt from tax. "Incorporated as a material or an integral part into tangible personal property for sale by such purchaser" means:

- (1) That the material must be physically incorporated into and become a component of the finished product;
- (2) The material must constitute a material or an integral part of the finished product; and
- (3) The tangible personal property must be produced for sale by the purchaser.

(e) Application of general rule.

- (1) Incorporation into the finished product. The material must be physically incorporated into and become a component part of the finished product.
- (2) Integral or material part. The material must constitute a material or integral part of the finished product.
- (3) The finished product must be produced for sale by the purchaser.

(Emphasis added).

Next, [45 IAC 2.2-5-15](#) provides:

(a) The state gross retail tax shall not apply to sales of any tangible personal property to a purchaser who purchases the same for the purpose of reselling, renting or leasing, in the regular course of the purchaser's business, such tangible personal property in the form in which it is sold to such purchaser.

(b) General rule. Sales of tangible personal property for resale, rental or leasing are exempt from tax if all of the following conditions are satisfied:

- (1) The tangible personal property is sold to a purchaser who purchases this property to resell, rent or lease it;
- (2) The purchaser is occupationally engaged in reselling, renting or leasing such property in the regular course of his business; and
- (3) The property is resold, rented or leased in the same form in which it was purchased.

(c) Application of general rule.

- (1) The tangible personal property must be sold to a purchaser who makes the purchase with the intention of reselling, renting or leasing the property. This exemption does not apply to purchasers who intend to consume or use the property or add value to the property through the rendition of services or performance of work with respect to such property.
- (2) The purchaser must be occupationally engaged in reselling, renting or leasing such property in the regular course of his business. Occasional sales and sales by servicemen in the course of rendering services shall be conclusive evidence that the purchaser is not occupationally engaged in reselling the purchased property in the regular course of his business.
- (3) The property must be resold, rented or leased in the same form in which it was purchased.

Finally, [45 IAC 2.2-4-27\(D\)\(4\)](#) states:

Supplies furnished with leased property. A person engaged in the business of renting or leasing tangible personal property is considered the consumer of supplies, fuels, and other consumables which are furnished with the property which is rented or leased.

In this case, Taxpayer used the raw materials to make parts that it used in two ways. Some parts were sold to customers in traditional retail sales and some parts were installed by Taxpayer itself into the equipment used in its rental/leasing activities. As provided by [45 IAC 2.2-15\(b\)\(3\)](#), the resale exemption only applies to TPP if it is sold or rented in the same form in which it was purchased. In this case, the raw materials undergo significant change prior to any sale or incorporation into rental/leasing equipment. Therefore, the percentage of Taxpayer's purchase of raw materials which are then used by Taxpayer for incorporation into its rental equipment is not eligible for the rental exemption.

For the traditional retail sales of parts directly to customers, [45 IAC 2.2-5-14\(b\)](#) provides that raw materials used to make parts subject to those sales are exempt from sales and use tax. However, [45 IAC 2.2-5-14\(b\)](#) also provides that the raw materials which Taxpayer used to produce tangible personal property for its own use are not exempt. A review of the documentation supplied in the protest process does not establish that the parts made from the raw materials in question were sold in transactions separate from the base rental/lease of the equipment. Taxpayer has not met the burden imposed under IC § 6-8.1-5-1(c).

In conclusion, Taxpayer has met the burden imposed under IC § 6-8.1-5-1(c) regarding the imposition of use tax on the TPP it rented to its customers in both rental with operator and leasing without an operator circumstances. Taxpayer has met the burden imposed under IC § 6-8.1-5-1(c) regarding the inclusion of replacement and repair parts for rental/leasing equipment in the Department's use tax compliance percentage calculations. Taxpayer has not met the burden imposed under IC § 6-8.1-5-1(c) regarding the imposition of use tax on raw materials it uses to fabricate parts for installation on rental/leasing equipment. The Department will conduct a supplemental audit to implement the portions of Taxpayer's protest upon which it has been sustained. After the recalculation of base tax, the Department will recalculate interest based on the revised base tax amount.

FINDING

Taxpayer's protest is sustained in part and denied in part, as provided above.

Posted: 04/30/2014 by Legislative Services Agency
An [html](#) version of this document.